

IN THE FINANCIAL SERVICES TRIBUNAL

Case no.: PA3/2022

In the matter between:

ESCAP SOC LIMITED

Applicant

and

THE PRUDENTIAL AUTHORITY

Respondent

Tribunal panel: LTC Harms (chair), Adv W Ndinisa and Mr PJ Veldhuizen

For the applicant: Adv A Cockrell SC and Adv A Friedman instructed by Cheadle Thompson Haysom Inc

For the respondent: Adv S Budlender SC and Adv B Dhladhla instructed by Allen & Overy (South Africa) LLP

Hearing: 28 March 2023

Date of decision: 4 April 2023

DECISION

- 1 The Applicant is Escap SOC Ltd. It is a wholly-owned subsidiary of Eskom SOC Ltd, and was incorporated to be a captive short-term insurer for Eskom. It derives 99% of its premium income from Eskom. As an insurer it

is a “financial institution” governed inter alia by the Insurance Act 18 of 2017 and the Financial Sector Regulation Act 9 of 2017 (“the FSRA”).

2 The Respondent is the Prudential Authority (“the PA”) established in terms of sec 32 of the FSRA). It is the responsible authority for the Insurance Act (see Schedule 2 of the FSRA). The objective of the PA is to (sec 33) –

- (a) promote and enhance the safety and soundness of financial institutions that provide financial products and securities services;
- (b) promote and enhance the safety and soundness of market infrastructures;
- (c) protect financial customers against the risk that those financial institutions may fail to meet their obligations; and
- (d) assist in maintaining financial stability.

3 In terms of sec 167(1) of the FSRA, the responsible authority for a financial sector law (in this case the PA) may impose an appropriate administrative penalty, that must be paid to the financial sector regulator, if the person – “has contravened a financial sector law”.

4 In other words, the jurisdictional fact for the authority to impose an administrative penalty is the contravention of (in this case) the Insurance Act and regulatory instruments made in terms of the Insurance Act (FSRA sec 1 s.v. “financial sector law”). Of relevance for the matter are Prudential Standard GOI 2 (“Governance of Insurers”) and Prudential Standard GOI 3 (“Risk Management and Internal Controls for Insurers”).

5 Having found that Escap had contravened provisions of the Insurance Act and of GOI 2 and 3, the PA imposed an all-in administrative penalty of R5million of which R3million was suspended on conditions.

6 One of the contraventions identified by the PA related to the declaration of a dividend by Escap of R600 million. Escap applies for a reconsideration of

this finding of the PA, accepting that it had contravened a financial sector law in respect of the other findings which related (in summary) to issues about new business take-on, the organisational structure, conflict of interest, lack of a succession plan, and absence of procedures to identify non-compliance with sec 30 of the Insurance Act.

- 7 The reconsideration application is in terms of sec 230(1) of the FSRA and the powers of this Tribunal are set out in sec 234(1).
- 8 The circumstances surrounding the dividend declaration are not in dispute and may be summarised as follows. Eskom had serious liquidity problems and requested Escap to invest R600 million in short-dated Eskom paper which the market was not prepared to take up. To have done so would, however, over-expose Escap to Eskom beyond the 20% limit for exposure to a single counterparty. It instead decided to declare and pay a dividend for that amount.

THE HAF REPORT

- 9 For purposes of a board meeting on 29 June 2021 to discuss Eskom's request, the Head of Actuarial Control Function ("HAF"), Mr Zondagh, prepared a document called "Assessing the Implications of a R600m Hypothetical Dividend" dated 18 June. Its stated purpose was to support the board's deliberations as to whether increase the 20% exposure limit but instead it considered the hypothetical situation from the perspective of a dividend.
- 10 It contains the input the Author would have given had the board, hypothetically, requested his opinion on the declaration of a dividend.

11 The Author explained that a dividend would constitute a permanent outflow as opposed to an investment or loan which would have remained an asset on the balance sheet. Some extracts from the report follow (underlining added for emphasis):

- For the purposes hereof, I used the unaudited 31 March 2021 position, as reflected in the March quarterly QRT, to express an opinion. Apart from being based on unaudited numbers, it should be expressly noted that the calculations, underpinning these results, to some extent rely on high-level approximations, as opposed to detailed, bottom-up calculations. This approach was necessitated due to the time constraints under which this exercise was undertaken. As such the purpose hereof is merely to provide broadly indicative views and the results should be interpreted accordingly.
- The key aspects of impact of a dividend, on which I can provide the Board with supporting information extends to [a] the impact on solvency, [b] the impact on asset-liability management and [c] the impact on the insurer's financial resilience. These three aspects are dealt with in the remainder of this note.
- **Solvency assessment:** As seen in the table below, a R600m dividend would result in a drop of the capital cover ratio from 1.61 (cum dividend) to 1.52 (ex-dividend). The Board's policy in this regard, is to "not declare or pay any dividend if such declaration or payment may result in a solvency cover ratio of less than 1.50". While getting close to 1.50, a R600m dividend would thus not have breached the Board's appetite in this regard.
- **ALM & liquidity assessment:** In order to assess the inter-relationship between assets and liabilities, and to test the availability of R600m of cash for the payment of a dividend, I view the insurer's asset-liability management (ALM) position using the following four distinct portfolios:
 - The Liability Portfolio (to which assets are first allocated to match liabilities),

- The Capital Portfolio (which should contain assets equal to 100% of the SCR),
 - The Buffer Portfolio (50% of the SCR, given the Board's intent to maintain a 1.5 SCR cover ratio), and
 - The Balance Portfolio (for all assets in excess of the first three portfolios, i.e. the remaining assets, after full provision for meeting all liabilities and protecting the Board's 1.5 SCR cover ratio).
- The next table shows how the total assets (R18.4bn) can be allocated to the different portfolios in a manner that achieves a degree of matching and still leave R600m cash available to the Balance Portfolio (from which a dividend could hypothetically be paid). As is evident, there is sufficient liquid assets to allow for a R600m dividend without material compromise to the ALM position.
 - **Conclusion:** I conclude, as far as the duties of the HAF is concerned, that there are no obvious reasons for me to advise the Board against the hypothetical payment of a R600m dividend at this time. The Board is reminded though of their duty to also consider all other relevant prudential, statutory, governance, etc. requirements in their current deliberations.

12 Some context for the first bullet point is required, which counsel explained in the following terms. The solvency capital ratio (SCR) forms the basis of the assessment of Escap's financial position to assess the prudence of declaring a dividend. The SCR is addressed in Quantitative Reporting Templates (QRTs). There is a difference between annual QRTs and quarterly QRTs. Escap is obliged to file a fully audited annual QRT within four months of the end of its financial year on 31 March (i.e., by 31 July). At the time of the Zondagh report, as it stated, all that was available was the quarterly 31 March 2021 QRT calculation and based on that quarterly QRT,

the solvency cover ratio went from 1.61 (cum dividend) to 1.52 (ex-dividend) should the dividend have been declared.

THE ACTUARIAL FUNCTION

13 The actuarial function, which was at the time being performed by Mr Zondag, is described in sec 14 of POI 3. The following references are relevant:

14.1: An insurer's actuarial function is responsible for expressing an opinion to the board of directors on the reliability and adequacy of the calculations of the insurer's technical provisions, and minimum and solvency capital requirements, including on:

- a) the appropriateness of the methodologies and underlying models used and assumptions made;
- b) the sufficiency and quality of the data used in actuarial calculations;
- c) best estimates and associated assumptions against experience when evaluating technical provisions;
- d) the accuracy of the calculations;
- e) the appropriateness of and impact of assumed future management actions and the effect of risk mitigation instruments; and
- f) the appropriateness of approximations or judgments used in the calculations due to insufficient data of appropriate quality.

14.4 An insurer's actuarial function is responsible for evaluating and providing advice to the board of directors, senior management and other control functions (where relevant) on:

- a) where the insurer uses the standardised formula to assess its risks, why that regulatory capital model is an accurate reflection of the insurer's own risk

profile, taking into account the board-approved risk appetite (and related risk limits), and business strategy.

...

d) the financial soundness position of the insurer, including the impact of any proposed dividend declaration or payment;

...

THE DECISION PROCESS

14 Escap's Audit Committee met on 28 June to discuss the finalisation of the external auditors' report (which, in draft form, was unqualified) and the Annual Financial Statements for the year ended 31 March 2021, both of which the Committee recommended to the Board for approval. It also dealt with a dividend declaration. The minutes record the following:

- The information and detail relating to the solvency and liquidity tests were shared with the meeting, relating to the proposed dividend payment of R600 million to the Shareholder.
- The meeting was taken through the solvency test requirements in terms of section 4(a) of the Companies Act and it was demonstrated that the company's assets fairly valued exceeded its liabilities.
- In terms of the liquidity test requirements, in terms of section 4(b) of the Companies Act, it was demonstrated to the meeting that through the liquidity ratios calculated ex and cum dividend (170% and 178.1% respectively), the company would meet the requirements 12 months after the date that the test was considered.
- The solvency capital requirement (SCR) ratio ex and cum dividend had been calculated by the Head of Actuarial Control Function (HAF) and was detailed in the HAF's paper.

- THE COMMITTEE RESOLVED THAT: That the Audit Committee recommends to the Board, approval of a distribution to the Shareholder (Eskom Holdings SOC Ltd) through a dividend payment; having considered the solvency and liquidity implications of the dividend proposal in terms of the Companies Act No.71 of 2008.

15 The meeting was then taken through the governance process relating to a proposed dividend to be declared by the Company and the minutes state:

- The requirements of the Insurance Act, in terms of the maintenance of a financially sound condition by the insurer (Escap) was highlighted to the Committee.
- The requirements of the Companies Act (section 46) were also highlighted to the Committee, which included the responsibilities and requirements of the Board in declaring a distribution to the Shareholder.
- Of note was that the Memorandum of Incorporation seemed to have an error, in that it required the Shareholder to approve the distribution to the Shareholder at the Annual General Meeting (AGM). The matter was discussed with the Group Company Secretary.
- The Committee requested the Group Company Secretary to provide a position relating to the requirement for approval at the AGM on 16 July, considering that the dividend payment was expected to be made by 05 July, if approved.
- THE COMMITTEE RESOLVED THAT: The Committee recommends to the Board, approval of the following:
 1. The Board acknowledges, in terms of section 46(1)(c) of the Companies Act No.71 of 2008, that that it has applied the solvency and liquidity test, as set out in section 4 of the Companies Act, and reasonably concluded that the company

will satisfy the solvency and liquidity test immediately after completing the proposed distribution.

2. That a distribution to the Shareholder (Eskom Holdings SOC Ltd) be made through a dividend payment;
3. That a dividend be declared in the amount of R600 million;
4. That the record date be 30 June 2021.

16 The Board of Directors of Escap met on 29 June 2021. The minutes record the following:

- The Committee discussed the request from Eskom regarding the additional investment into the Eskom commercial paper bills (CPBs). The Committee revisited the previous note to it from Mr Zondagh, as the Head of Actuarial Control Function.
- The Committee reiterated that Escap should only consider its requirements and not that of its shareholder when making investment decisions. Any investment into the Eskom CPBs would need to be an arms-length transaction, where applicable, and the further exposure to Eskom instruments would also need to be considered.
- The Committee considered various options, as indicated in the Committee's report, and a dividend payment option was preferred and recommended. Liquidity and asset-liability matching were reviewed as well as the resilience of the company, should a dividend be declared. While the dividend was a permanent outflow of funds from the company it was the most appropriate means, considering the above matters.
- In the Head of Actuarial Control Function's report, he highlighted some risks for the Board to consider. This was in the context of considering Eskom's request for additional investment in its CPBs while underwriting other policyholders.

- The Committee worked on the assumption that Escap would continue to underwrite the other policyholders and the request from Eskom was discussed in that context. For the next ORSA it would be assessed what the appropriate level of exposure would be to Eskom going forward.
- 17 It is unnecessary to quote the balance of the discussion save that the Board eventually resolved that
1. The Board acknowledges, in terms of section 46(1)(c) of the Companies Act No.71 of 2008, that that it has applied the solvency and liquidity test, as set out in section 4 of the Companies Act, and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.
 2. That a distribution to the Shareholder (Eskom Holdings SOC Ltd) be made through a dividend payment;
 3. That a dividend be declared in the amount of R600 million;
 4. That the record date be 30 June 2021.
- 18 The AGM of Escap, which had been scheduled for 31 July, was moved to 16 July, when the declaration and distribution of the dividend of R600million were approved.
- 19 To summarise: the FYE was 31 March; the shareholder sought an urgent investment of R600million in value paper; the actuary could not justify it; the actuary reported hypothetically on the declaration and payment of a dividend in the like amount on 18 June; the Audit Committee met on 28 June; the Board met on 29 June; the AGM was on 16 July and approved the dividend; and payment was immediate.

THE FACTS WERE WRONG

- 20 So far so good, but matters did not end there. As mentioned, the Zondag report was based on the 31 March QRT, as were the consequent decisions by the Audit Committee, the Board and the AGM. It soon transpired, as a matter of fact within days after the AGM, that the SCR had been overstated in that interim report.
- 21 According to the draft annual QRT, the solvency cover ratio was 1.38 (cum dividend) and 1.30 (ex-dividend) and not 1.61 (cum dividend) to 1.52 (ex-dividend). The dividend could not have been declared at that ratio. The minimum was 1.50.
- 22 Escap explained the discrepancy on the basis that there was an “overstatement” (the quotation marks are those of counsel) caused by a previously overly-aggressive allowance for loss absorption by taxes (i.e., loss-absorbing capacity of deferred tax or “LACDT”), a dramatic increase in the Incurred But not Reported (“IBNR”) Claims and the underestimation of market risk. The LACDT change was a result of the correction of an error in prior years made by the first-line actuarial resource (Marsh), which was picked up by the newly-appointed Head of Actuarial Control Function in his first year-end QRT review [due on 31 July] as at 31 March 2021.
- 23 The PA was already in the process of investigating the business of Escap and it had identified the miscellaneous contraventions summarised above but, although concerned about the dividend declaration, it was not identified as a contravention. A presentation to the PA Regulatory Action Committee listed (probably in August) the other contraventions and proposed the penalty that was eventually imposed for them as well as the later added dividend “contravention”.

24 The recommendation at the time about the dividend was that Escap should be directed to reverse the dividend declared “as due process” was not followed by utilising sec 143(1) read with sec 146 of the FSRA. Eventually, the decision was made that a directive be issued in terms of sec 143, prohibiting Escap from paying any further dividends for a period of 12 months.

25 In the event, the PA issued a letter of intent dated 14 September 2021 with the following heading:

Intention to issue a penalty to Escap SOC Limited in terms of section 167 of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) for the contravention of sections 30 and 31 of the Insurance Act 2017 (Act No.18 of 2017) as well as Prudential Standards for Governance of Insurers 2 and 3.

26 After having dealt with the other contraventions, the PA turned its attention to the dividend issue and stated the following:

- a) Section 8.1 of the Prudential Standard GOI 2 states that the board of directors of an insurer is responsible for the effective governance of the insurer. In exercising that responsibility, the board of directors must, amongst other responsibilities, set and implement governance arrangements to ensure reliable and transparent financial reporting for public and supervisory purposes.
- b) The PA found that the Board failed in its oversight responsibility to ensure reliable and transparent financial reporting to the PA. This is evident from the incorrect reporting which, amongst other things, included an overstated solvency position that formed the basis of the decision by the Board to declare a dividend of R600 million to the shareholder (Eskom SOC Limited) in July 2021.

- c) As is evident from the minutes of the meeting of the board of directors held on 29 June 2021, the abovementioned dividend was declared to address liquidity challenges of the shareholder (Eskom SOC Limited). This conduct is tantamount to financial assistance which requires prior approval in terms of section 38(1)(e) of the Insurance Act and is also prohibited by the insurer's Memorandum of Incorporation. Furthermore, the PA noted that Escap did not follow due process as laid out in the board approved dividend policy.
- d) Furthermore, based on the solvency and liquidity test done by Escap, the impact of the dividend on the Escap's financial position was that the Solvency Cover Ratio (SCR) would decrease from 1.61 (cum dividend) to 1.52 (ex-dividend).
- e) However, according to the report from Escap's Head of Actuarial dated 29 July 2021, prior to the dividend declaration, Escap's SCR ratio was materially overstated and should have been 1.38. This was mainly due to the SCR being understated by R854m, which in turn was mainly caused by an overly aggressive allowance for loss absorption by taxes and the underestimation of market risk.
- f) The PA found that in the declaration of the dividend, the board failed in its oversight responsibility to act with independence of mind in pursuing the best interests of the insurer, policyholders and other stakeholders, as well as to take into account the long- term financial soundness of the insurer as a whole, the interests of its policyholders and other stakeholders, and the fair treatment of customers.

THE PA'S GROUNDS

- 27 It follows from par (d) and (e) that the main issue was the earlier overstatement of the SCR ratio and the acceptance thereof by the Board and the consequent impact of the dividend declaration on the SCR, which was based on incorrect assumptions. Had there been any doubt that this was the PA's intention, the letter imposing the penalty made the position clear: the Board contravened sec 8.1 of GOI 2,¹ it said, having failed in its oversight responsibility to ensure reliable and transparent financial reporting – and the QFR of 31 March reported the SCR ratio incorrectly, which led to the dividend declaration. In other words, it was not the declaration itself that formed a contravention, it was the 31 March QFR which was, in any event, the responsibility of the HAF and not the Board.
- 28 It is apparent, as it was to the PA's counsel who abandoned the ground, that the PA misunderstood its own regulations in searching for a “contravention” peg in relation to the dividend declaration.
- 29 The next ground mentioned was the failure of the Board to follow due process in declaring the dividend. This ground was expanded in the PA's further grounds but was, once again, not pursued by counsel and it can be discounted for purposes of this decision.
- 30 The third ground, namely that the declaration was tantamount to financial assistance without the PA's prior consent was also abandoned during the hearing because of clear authority that the declaration of a dividend for whatever reason does not amount to “financial assistance” to a shareholder:

¹ The intention was to rely on 8.1(j): The board of directors of an insurer is responsible for the effective governance of the insurer. In exercising that responsibility the board of directors must . . . set and implement governance arrangements to ensure reliable and transparent financial reporting for public and supervisory purposes.

Re Wellington Publishing (1973) 1 NZLR 133; *Novick v Comair Holdings Ltd* 1979 2 SA 116 (W) at 136H and [Constantia Insurance Company Limited v The Master of the High Court, Johannesburg and Others \(512/2021\) \[2022\] ZASCA 179 \(13 December 2022\)](#).

31 Counsel for the PA simplified matters and submitted that

The Board knew that the finalisation of the annual QRT was imminent. Further, the Board knew that the annual QRT would be more accurate than the quarterly QRT. We submit that when contemplating a dividend as large as R600 million, a reasonable and prudent board acting in the best interests of an insurer would be inclined to await accurate figures that it knows would become available within a matter of days. Indeed the annual QRT reflecting the correct solvency position was made available to the Board on 26 July 2021.

32 That meant, according to counsel, that Escap contravened sec 30(1)(a) of the Insurance Act which states (redacted) that an insurer must

adopt, implement and document an effective governance framework that provides for the prudent management and oversight of—its insurance business, and which adequately protects the interests of its policyholders.

SHIFTING GROUNDS

33 This raised the debate whether this Tribunal can “reconsider” a decision taken on contravention x and find the applicant “guilty” of contravention y. We dealt with the same problem in the recent decision, namely *Nigel James Green v FSCA* Case A21/2022 of 4 and 18 January 2023. The facts were different because in that case there was no relationship between the x and y, the main question being whether the applicant knew what the gist or substance of the case was.

- 34 In this case Escap's attention was specifically drawn to sec 30 in general and the finding in (f) spelt out the gist of the case against Escap. This is an administrative process and particularity as required in for instance a criminal indictment is not required. We therefore hold that we are empowered to consider whether the Board implemented its governance framework in a manner which adequately protected the interests of policyholders.
- 35 It appears from the exposition above that the Board ticked all the right boxes and that, formally, its decision was in order. The problem though is that it did not take sufficient note of the caveats raised by Mr Zondagh and one cannot escape the conclusion that the interests of the shareholder trumped the interests of policyholders (Eskom was not the only one). Had it not been for the pressure of Eskom's needs, the Board, in our estimation, would have not considered the declaration of the dividend before the annual QRT report and the final audited statements were available. It was a rushed process – and that is not an ex post facto assessment. Everyone involved knew that they had to rush matters.
- 36 We accordingly conclude that the jurisdictional fact for a decision in relation to the dividend issue was present and that the PA was entitled to consider imposing a financial penalty as it did.

FINANCIAL PENALTY

- 37 That brings us to the penalty imposed by the PA, namely R5million of which R3million was suspended. The penalty, in objective terms and compared to other penalties imposed by the PA or the FSCA, is lenient. It will be recalled that this is the same penalty that the PA initially thought "fitted the other

crimes” without the dividend issue which, on balance, is the most serious of the contraventions.

38 We have repeatedly held that, in relation to the penalty,

The ordinary rule is that a higher body is not entitled to interfere with the exercise by a lower body of its discretion unless it: failed to bring an unbiased judgment to bear on the issue; did not act for substantial reasons; exercised its discretion capriciously; or exercised its discretion upon a wrong principle. There is no reason why we should not apply the same approach during an application for reconsideration.

39 Escap listed and argued all the conceivable factors in its application, but counsel was more selective and highlighted four. Two were expressly considered by the PA, namely that Escap cooperated fully with the PA and that it put measures in place to prevent a recurrence of the events.

40 The other two were that it is industry practice to rely for important decisions on quarterly reports and that the Board was not “reckless” in following this commonly-accepted approach. But as the PA’s counsel pointed out, there is no evidence that it is industry practice to declare dividends on quarterly reports and, one may add, the Board did not rely on the quarterly reports but on that of Mr Zondagh, and it did not take sufficient heed of his qualifications and the conclusion, which he carefully drafted in negative terms, namely “as far as the duties of the HAF is concerned, that there are no obvious reasons for me to advise the Board against the hypothetical payment of a R600m dividend at this time.” The Board took a calculated risk by making a decision on the Zondagh report which potentially could have put policyholders at risk. The ultimate responsibility for the declaration, as the report stated, was that of the Board.

CONCLUSION

41 The application for reconsideration is dismissed.

Signed on behalf of the Tribunal on 4 April 2023.

A handwritten signature in black ink, appearing to read "LTC Harms", enclosed in a thin black rectangular border.

LTC Harms (chair)